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SETTLEMENT GUIDELINES

MEMBERSHIP PAYMENTS MADE TO INDUSTRY-CREATED RESEARCH ORGANIZATIONS

ISSUE

Whether membership payments, or any portion thereof, made to nonprofit organizations of a specific industry constitute "contract research expenses" for purposes of computing the research credit under section 41 of the Internal Revenue Code.

BACKGROUND

This coordinated issue was approved by the Office of Chief counsel on July 1, 1993. Although this issue is generic for all industries, this guideline paper is applicable only to the utility industry. It pertains to the research credit issue *for* years after 1985.

Members of the nonprofit organization are not able to claim the research credit for an allocable portion of membership dues unless the payments are for qualified research. To the extent that the membership payments paid to the nonprofit organization are used for qualified research, such payments constitute amounts paid or incurred to any person (other than an employee of the taxpayer for qualified research). For purposes of computing the research credit under I.R.C. S 41, 65t of that portion of the membership payments made by the members of the nonprofit organization that is allocable to qualified research will be treated as contract research expenses. See I.R.C. S 41(b)(3). To the extent that their membership payments are used for qualified research, only the members of the nonprofit organization who make payments under the membership agreement and on whose behalf the qualified research is conducted can claim the credit; the nonprofit organization which conducts (or contracts for) the research on behalf of its members cannot claim the credit *for* its expenditures in performing *the* contract.

Furthermore, it is important to note that although there are differences between sections 47. and 174, there are close ties between research and experimental expenditures under section 174 and the research credit under section 41. Under section 41(d) , qualified research is defined, in part, with reference to section 174 as follows: the term "qualified research" means research with respect to which expenditures may be treated as expenses under

section 174. However, it should also be noted that a business deduction for research and experimental expenditures under *section* 174 must be reduced by the amount of the research credit. I.R.C. § 280C (c) (1) .

FACTS

Several industry groups have formed separate non-profit corporations to promote, engage in, conduct and sponsor research and development relating to their respective industry products.

The nonprofit organization performs additional functions including litigation, studies for potential litigation, dissemination of information, and gathering and analyzing statistics. Typically these industry-created nonprofit organizations are granted recognition of exemption from Federal income taxes under I.R.C. § 501 (c)(3). These nonprofit organizations are intended to provide a medium through which all members of the industry can sponsor industry--related research in both the pure and applied sciences. They also prepare and disseminate information and data for the research. The management of these entities is usually handled by a Board of Directors and several advisory committees- Industry members are represented on the advisory committees and assist in identifying the research and development needs of the industry.

In addition to disseminating information and data for the research to the industry members, these organizations typically make the results of their research and other information available to the public on a nondiscriminatory basis for payment of a nominal fee. Dissemination of the information is made through published research reports, meetings, workshops, seminars, news releases, motion picture films, monthly periodicals and by other means. In addition, inventions and computer codes resulting from the research activities of these entities are available to the public under licensing arrangements.

These entities are usually structured as membership organizations with no outstanding shares of capital stock. Persons, firms, government agencies or corporations committed to a national program for research and development in the Utility Industry are eligible for membership.

The research and development programs, the program management expenses, and other expenses of the organizations are financed by membership payments. The Board of Directors base the members payments on either a fixed fee and/or a formula that uses specific member data.

The membership agreements typically state that the organization will conduct its activities and operations for some or all of the following purposes:

1. To promote, engage in, conduct and sponsor research and development with respect to industry products and all activities directly or indirectly related thereto;
2. *To provide a medium* through which investor-owned, government-owned and cooperative--owned entities and all other persons interested in the industry can sponsor industry research and development for the public benefit;
3. To promote, engage in, and conduct research in both pure and applied sciences for the advancement and betterment of industry products;

To sponsor scientific research and development with respect to industry-related matters with a view towards providing economical, reliable service to customers

5. To seek and ascertain, through scientific research and development, *solutions* to environmental problems related to industry operations;
6. To discover, devise, develop, invent and create, through study and research, the methods and means to improve industry-related product;
7. To undertake, conduct, engage in or direct research and development activities for the discovery or improvement of new or more efficient forms of industry products, including new or more efficient uses of industry products.
8. To discover and develop, *through* scientific study and research, ways and means to protect, ,conserve and maximize the efficient utilization of finite natural resources used in industry *organizations*.
9. To provide a medium for coordination and the exchange of information for all organizations and persons, public or *private*, concerned with scientific research and development in the industry; and
10. To ascertain, prepare and disseminate information and data with respect to scientific research and development activities in the industry.

In addition, the membership agreement typically states that in consideration for the financial support, encouragement and participation of the member signing the agreement the nonprofit organizations shall:

conduct during the term of this Agreement, for the benefit of the member and other members, and for the public benefit, a program of research and related activities consistent with the purposes of and approved by its Board of Directors and shall provide, from time to time to the member and to others, analyses and reports documenting the plans, progress and results of the activities and operations of the nonprofit organization.

These nonprofit organizations do very little, if any, research themselves but instead enter into contracts with outside third-party research firms. The payments made to these research firms are categorized into research projects. The research projects are generally large in scope and may involve a number of individual third-party contracts. A significant portion of the nonprofit organization's expenditures relate to these contracts.

Other expenditures incurred by these nonprofit organizations include general and administrative costs, training costs and market research costs.

EXAMINATION DIVISION'S POSITION

Please note: Although this guideline pertains to post-1985 cases, this section continues to rely on pre-1986 analysis *under I.R.C. § 174* since this guideline deems it inappropriate to alter Examination Divisions Position as it appeared in., the approved coordinated issue. Because the changes in the Tax Reform Act of 1986 (1986 Act), section 231 of P.L. 99-514, 1986-3 C.B. (Vol. 1) 1, 90, clarify

§ 41 should be emphasized rather than I.R.C. § 1,74. For example, under S 41(d)(4)(A) research conducted after the beginning of commercial development of the business component is excluded from the definition of qualified research. The legislative history to the 1986 act explains that this exclusion applies to the costs of preproduction planning for a finished business component, "trouble-shooting" involving detecting faults in production equipment or processes, and the cost of "debugging" product flaws. See H.R. Rep. No. 841, 99th Cong. 2d Sess. II 74-75 (1986), 1986-3 C.B. (Vol. 4) 74-75. Some of these costs may be eligible *for expensing* under S 174.

The Examination Division have determined that the following activities are not qualified research:

1. Literature reviews. These projects contain payments for literature reviews relating to research matters. These expenditures are usually incurred early in the project and before any laboratory or experimental work is performed. Although Research does not have to occur in a laboratory because I.R.C. 174 requires that qualifying expenditures be for research in the "laboratory or experimental" sense, literature reviews do not qualify as Section 174 expenditures. This determination also prevents these types of expenditures from qualifying as I.R.C. S 41 expenditures.

Technology Transfers. These expenditures are for workshops, seminars and training sessions. They also include the costs to publish and disseminate handbooks or manuals explaining the research. These expenditures are not research and development costs in the experimental or laboratory sense. In addition, S 1.174-2(a) (1) excludes from the definition of the term "research or experimental expenditures" expenditures paid or incurred for research in connection with literary, historical or similar projects. Consequently, these costs are not qualified expenditures under I.R.C. § 174 or I.R.C. 541.

Foreign Research. Some projects are contracted with foreign entities where the work is performed outside the United States. In addition, some of the domestic entities contracted with, in turn, may subcontract with foreign entities who perform research outside the United States. I.R.C. Section 41(d)(4)(F) states that qualifying research does not include research conducted outside the United States. Thus, any expenditures associated with work conducted outside the United States would be disallowed.

Demonstration or Adaptation of Existing- Technology. Certain projects or portions of projects may be found to contain expenditures relating to work that used existing technology. The purpose behind these types of costs is not the discovery of new knowledge, but merely the attempt to show how previously acquired knowledge could be commercially exploited and/or used in the industry. Some projects may involve costs in the construction of commercial-size facilities whose technological feasibility has been previously established by test, prototype and/or large scale facilities. Any expenditures found to have been incurred in the planning, development, or actual construction of a demonstration facility would be deemed not to qualify for the R&E credit permitted by I.R.C. 541. In addition, any project expenditures that are determined to be solely for adapting existing technology to the particular needs of the industry or the reproduction of an existing business component would be similarly disallowed. I.R.C. S 41 (d) (4) (B) or (C) .

Software Costs. In general, software costs are to be reviewed for purposes of I.R.C. § 174 in the same manner as any other research costs. See Notice 87-12, 1987-1 C.B. 432. In addition, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer other than for use in an activity which constitutes qualified research is disallowed.

Trouble -shooting; Quality control. I.R.C. S 174 and 41 require that expenditures be in the experimental or laboratory sense. Ordinary testing or debugging does not qualify. These types of costs come after the technology has been established and are primarily incurred when relatively minor problems have occurred. As these expenditures are not connected with or in the nature of laboratory or experimental work, they would be disallowed.

Market or Economic Survey. Projects that are associated with "equipment or processes" will generally include a contract for a survey as to the marketability or commercial feasibility of the new or improved equipment/process. Since these contracts do not reflect expenditures for research in the "laboratory or experimental sense" and actually arise after the development of the technology, the expenditures are not qualifying expenditures under I.R.C. S 41(d) (4) (D) .

Non-R&E Data Collections. similar to literature reviews, these data collections typically are undertaken prior to the decision to perform any laboratory or experimental work and are not related to any research work actually underway. The value or benefit of such data collections are to assist management in its decisions as to future research endeavors. since such costs are not for research in the "laboratory or experimental sense," they are deemed to be non-qualifying expenditures for purposes of Sec. 41(d) (4) (D) .

General and Administrative Costs. Generally, a research organization's general and administrative costs are not qualified research expenditures; however, .costs for services which, if performed by employees of the member(s), would constitute qualified services within the meaning of x . R. C. § 41(b) (2) (B) are contract research expenses. See Treas. Reg. 1.41-2(e) (1)(ii).

Under Treas. Reg. 1.41-2(c), direct supervision constitutes qualified services and as such qualifies for the credit whereas supervision by higher-level managers does not. Where a contract, for example the membership agreement, calls for activities other than qualified research or qualified services, only 65% of the portion allocable to qualified research or services is a contract research expense. Accordingly, to the extent these expenditures are documented as constituting qualified research (not only for the credit year but also for determining the base period or base amount), they are qualified contract research expenses- see, e.g., Research. Inc. v. United States 76 AFTR 2d Para. 95-5162; and Grindle y. Commissioner, T.C. Memo 1993-297.

TAXPAYER'S POSITION

The taxpayer contends that the amounts paid to the nonprofit organization constitute qualified research expenses under I.R.C. Sec. 41(b)(1) and are eligible

1. Literature Reviews - Such reviews are the first steps in research and are essential parts of the research. They also avoid duplication of previous work and may determine how the research should proceed. Alternatively, even if a review of the relevant literature on a research topic is not considered part of qualifying research, it should be considered part of the cost of administering the research, i.e., as overhead.
2. Technology Transfers -- Workshops, seminars, and training sessions are a means of passing on or disseminating the results of the research; handbooks and manuals serve the same function. All of the above disseminates the results of research and are therefore, like research reports. If the costs of research reports qualify for the credit, then the costs of workshops, seminars, training sessions, handbooks, and *manuals* should also qualify. Alternatively, even if they are not part of research, they, should be treated as overhead costs and should not be considered as non-research expenditures.
3. Demonstration Projects - Demonstration projects represent full scale models of a technology proven at a bench or pilot scale and typically the models have many unanticipated technological problems. Therefore, expenditures for demonstration projects, even those for commercial size facilities, should be treated as qualifying expenditures.
4. Software Costs - If software costs are incurred with respect to qualified research activities then they are allowable for the research credit. See Notice 87-12, 1987-1 C.B. 432.
5. Trouble-Shooting; Quality Control - The taxpayer believes that these costs represent qualified research.
6. Market or Economic Surveys - These expenditures are often incurred as a step in determining what research should *be* undertaken and as such, are integral parts of the research process and should qualify for the credit. Alternatively, if they do not, *these* expenditures should be considered as part of *the* overhead incurred in administering the research program.
7. Non-R&E Data Collections - This data collection relates to management and is an essential part of the research process. Therefore, these costs should not be *treated* as non-qualifying expenditures. Alternatively, even if is considered not research, these expenses should be covered by the statutory 35% rule.

LEGAL DISCUSSION

The research credit provisions originally were enacted as I.R.C. § 44F by Section 221 of the Economic Recovery Tax Act of 1981, P. L. 97-39, 1981-2 C.B. 256, 357. I.R.C. 5 44F applied to expenses paid or incurred after June 30, 1981 through all taxable years beginning before January 1, 1984. I.R.C. g 44F was redesignated as I.R.C. g 30 by Section 471(c)(1) of the Deficit Reduction Act of 1984, P.L. 98-369, 1984-3 C.B. (Vol. 1) 1, 334. I.R.C. S 30 was effective for

I.R.C. S 30 was redesignated as I.R.C. g 47. by Section 231(d)(2) of the Tax Reform Act of 1986, P.L. 99-514, 1986-3 C.B. (Vol.i)1, 334. I.R.C. § 41 Xs effective *for all* taxable years beginning after December 31, 1985, and before July 1, 1995. For purposes of this settlement guideline, all references will be made to I.R.C. S 41.

Section 41 provides a tax *credit* for qualified research expenses paid or incurred by a taxpayer during the taxable year. The credit is an incremental credit equal to the sum of 20 percent of the excess of the taxpayer's qualified research expenses for the taxable year over a base amount, and 20 percent of the taxpayer's basic research payments.

For tax years beginning before January 1, 1990, the base amount used in computing the research credit is the average of the taxpayer's qualified research expenses for the 3 years preceding the credit year. This amount is called the base period research expenses. The base period research expenses cannot be less than 50 percent of the credit year qualified research expenses.

For taxable years beginning after December 31, 1989, the base amount is the product of a fixed-base percentage and the average annual gross receipts of the taxpayer for the four taxable years preceding the credit year. However, a taxpayer's base amount cannot be less than 5096 of its credit-year qualified research expenses.

Generally, a taxpayer's fixed-base percentage is its aggregate qualified research expenses for all taxable years beginning after December 31, 1983, and before January 7., 1989 (the fixed-base period) divided by its aggregate gross receipts for the same period. However, the maximum *fixed-base* percentage is 16% and 41 (c) (3) (B) provides *special* rules for determining the fixed-base percentage for taxpayers that do not have both qualified research expenses and gross receipts in at least three taxable years of the fixed-base period.

I.R.C. § 41(b) (7.) defines the term "qualified research expenses" as the sum of the amounts paid by the taxpayer for "in-house research expenses" and "contract research expenses" which are paid or incurred by the taxpayer during the taxable year in carrying on a trade or business of the taxpayer. Y. R. C. S 41 (b) (2) defines the term "in-house" research expenses to include wages paid or incurred to an employee for qualified services performed by such employee, and amounts paid or incurred for supplies used in the conduct of qualified research.

I. R. C. § 41 (b) (2) (B) defines qualified services as consisting of (i) engaging in qualified research, or (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research. If substantially all of the services performed by an individual for the taxpayer during the taxable year consists of services meeting the requirement of (i) or (ii) above, the term "qualified services" means all the services performed by such individual for the taxpayer during the taxable year. See also Treas. Reg. § 1.41-2(c).

I.R.C. § 41(b)(3) and Treas. Reg. 1.41-2(e) define the term "contract research expenses" as 65% of any amount paid or incurred, in carrying on a trade or business, to any person (other than an employee of the taxpayer) for the performance, on behalf of the taxpayer, of qualified research or services, which if performed by the taxpayer, would constitute qualified services. Where the

contract calls for services other than qualified research or qualified services, only 65% of the portion of the amount paid or incurred for qualified research or services is a contract research expense. Treas. Reg. 1.41-2 (e) (1) .

Under the regulations, an expense is paid or incurred for the performance of qualified research only to the extent it is paid or incurred pursuant to an agreement that:

- (i) Is entered into prior to the performance of the qualified research,
- (ii) Provides that research be performed on behalf of the taxpayer,
- (iii) Requires the taxpayer to bear the expense even if the research is not successful.

Treas. Reg. 1.41-2 (e) (2) . The determination of whether payments from a taxpayer to another person constitute contract expenditures for research to be conducted on behalf of the taxpayer depends on all the facts and circumstances of the particular research arrangement. H.R. Rep. No. 97-201, 97th Cong., 1st Sess. 17.9 (1981), 1981-2 C.B. 332, 362. See also, Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, 128.

For taxable years beginning after December 31, 1985, the term "qualified research" means research with respect to which expenditures may be treated as expenses under I.R.C. 5 174 which is undertaken for the purpose of discovering information (i) which is technological in nature, and (ii) the application of which is intended to be *useful in' the* development of a new or improved *business* component of the taxpayer, and (iii) substantially all of the activities of which constitute elements of a process of experimentation for a new or improved function, performance or reliability or quality.

In addition, § 41(d) (4) lists several exclusions from the definition of the term "qualified research". These exclusions include:

(i) RESEARCH AFTER COMMERCIAL PRODUCTION. - Any research conducted after the beginning of commercial development of the business component.

(ii) ADAPTATION OF EXISTING BUSINESS COMPONENTS. - Any research related to the adaptation of an existing business component to a particular customer's requirement or need.

(iii) DUPLICATION OF EXISTING BUSINESS COMPONENT. - Any research related to the reproduction of an existing business component (in whole or in part) from a physical. examination of the business *component itself or from* plans, blueprints, detailed specifications, or publicly available information with *respect to* such business component.

(iv) SURVEYS, STUDIES, ETC. - Any

- (1) efficiency survey,

(3) *market* research, testing, or development (including advertising or promotions),

(4) routine data collection, or

(5) routine or ordinary testing or inspection for quality control.

(v) COMPUTER SOFTWARE. - Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in-

(1) an activity which constitutes qualified research (other than the development of the internal use software itself),

(2) a production process with respect to which the requirements of qualified research are met.

(vi) FOREIGN RESEARCH. - Any research conducted outside the United States.

(vii) SOCIAL SCIENCES, ETC. - Any research in the social sciences, arts or humanities.

(viii) FUNDED RESEARCH. - Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Section 1.174-2(a)(1) of the regulations defines the term research or experimental expenditures. Generally, the definition in section 1.174-2(a)(1) provides that research or experimental expenditures are those "which represent research and development costs in the experimental or laboratory sense." The regulations provide that the term specifically includes all such research and development costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned.

On October 3, 1994, the Service published final amendments to 1.174-2 of the regulations in the Federal Register. These amendments clarify the definition of research or experimental expenditures and provide guidance regarding the reasonableness requirement of section 174(e). Section 174(e) was added to the Internal Revenue Code by section 7110(d)[(e)] of the Revenue Reconciliation Act of 1989, P.L. 101-239, 1990-1. C.B. 210, 227. Under the *new* regulations, expenditures represent research *and* development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning *the* development or improvement of a product. Uncertainty exists if *the* information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or

product or improvement represents. The final amendments apply to taxable years beginning after October 3, 1994. However, because the amendments merely clarify the existing definition of research *yr experimental* expenditures, return positions for prior years that are consistent with the amendments will be consistent with the regulations as they existed before the amendments.

The following expenditures are excepted from the definition of *research and experimental* expenditures:

- a. expenditures for ordinary testing or inspection of materials or products for quality control; ,
- b. expenditures for efficiency surveys, management studies, consumer surveys, advertising, or promotions;
- c. the costs of acquiring another's patent, model, yr production process;
- d. expenditures 3.n connection with literary, historical, or similar projects involving the production of property, including the production of films, sound recording, video tapes, books or similar properties;
- e. acquisition or improvement of land or property subject to *the allowance for* depreciation under section 167 or depletion under section 611; and
- f. research or experimentation in connection with the construction or manufacture of depreciable property by another unless made to the taxpayer's order and at his risk.

Section 1.174-2(a) (4) clarifies that the exclusion for quality control testing does not apply to testing to determine if the design of a product is appropriate. Therefore, the cost of validation testing to ensure that a product design meets its intended objectives is a research and experimental expenditures.

The case law predominantly covers the deduction under I.R.C. S 174 rather than the research credit under I.R.C. § 41. In the case of Mayrath v. Commissioner, 41 T.C. 582 (1964), *aff'd on another issue*, 357 F. 2d 209 (5th Cir. 1966), the taxpayer claimed certain expenses incurred in connection with building an "experimental" house as Section 174 deductions. The Tax Court in support of the commissioner, found:

"the regulatory definition [of research or experimental expenditures in section 1.174-2 (a) (1)] to be reasonable and consistent with the intent of the statute to limit deductions to those expenditures of an investigative nature expended in developing the conceit of a model or product." Mayrath, at 590 (emphasis added). See also Reiner v. Commissioner, T.C. Memo 1965-197.

In Agro Science Company, T.C. Memo 1989-687, *aff'd*, 927 F 2d 213 (5th Cir. 1991), the court held that several partnerships in the diagnostic health care business were not entitled to any deduction for research and experimental expenditures under I.R.C. S 174 in connection with the development of monoclonal antibody conjugates by an unrelated corporation on behalf of the partnerships. Although producing the conjugates was "clearly scientific work," the services performed by the corporation were not investigative in nature, but, rather, were deemed routine in nature.

In the case of TSR. Inc. and Subsidiary v. Commissioner, 96 TC 903 (1991), the

games and game-related products. In developing the games, the taxpayer conducted research on the various topics which formed the basis of the games. The information derived from the research was incorporated into the mechanics of the particular *game*. *The court* held that the I.R.C. Section 41 credit only applies to research that is scientific or technological in nature. Research and game development conducted by the taxpayer was determined not to be scientific or technological in nature and therefore does not qualify for the I.R.C. 541 credit.

In Yellow Freight system, Inc. of Del., 924 Cl. Ct. 804, 92-1 USTC 50,029 (1991), which involved nine software programs for accounts receivable, freight shipments, freight billings, pricing, licensing, etc., the court rejected a scientific definition of research holding instead that expenditures will qualify under I.R.C. S 41, "if the software produced was either new or a significant improvement from that which existed previously."

Hence, of those cases which proceeded to trial most were factual determinations and although the government prevailed, they are of limited legal precedential value.

However, two cases dealing with substantiation are particularly noteworthy. In Carl E. Grindle, T.C. Memo 1993-297, the taxpayer failed to produce records to substantiate the existence of research and development expenditures. The court indicated substantiation of research and development expenditures "requires more than consistency and sincerity. It requires recordkeeping and other substantiating evidence." Moreover, the taxpayer was not entitled to a deduction for research and development expenditures because he failed to produce any evidence that the expenditures were made in connection with a trade or business.

In Research, Inc. v. U.S., 76 AFTR2d 95-5688 the taxpayer claimed the research and development credit for 1985 only on those expenditures related to its standard product line. It later filed a claim for additional research credit on its "unique" systems projects. For the years 1982-1984, the base years, the taxpayer had claimed the research credit for only its standard project. line even though expenditures were made for its unique systems projects. The taxpayer did not adjust its base period expenses to reflect its expenditures on its unique products and further admitted it could not substantiate them. The court held in the absence of some evidence that the amounts of qualified research expenditures attributable to both lines of its product were accurate, the taxpayer was barred from claiming the additional credit. without such accounting, the taxpayer could not show either initial qualification or the increase in the average expenditures over the prior 3 years.

Lastly, two revenue rulings are pertinent to this area. In Rev. Rul. 80-245, 1980-2 C.B. 72, a public utility company conducted and paid another organization to conduct environmental impact studies to support its application to state *regulatory agencies* to expand its generating facilities. The ruling holds that the taxpayer's expenditures for environmental impact studies prepared in connection with the expansion of its facilities are not research and experimental expenditures within the meaning of section 174 of the code.

Similarly, in Rev. Rul. 73-395, 3.973-2 C.B. 87 costs incurred in the writing,

and visual aids do not constitute research and experimental expenditures under section 174 of the Code.

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